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ABSTRACT

This instructor guide for a unit on business financing in the PACE (Program for Acquiring Competence in Entrepreneurship) curriculum includes the full text of the student module and lesson plans, instructional suggestions, and other teacher resources. The competencies that are incorporated into this module are at Level 1 of learning--understanding the creation and operation of a business. Included in the instructor's guide are the following: unit objectives, guidelines for using PACE, lists of teaching suggestions for each unit objective/subobjective, model assessment responses, and overview of the three levels of the PACE program. The following materials are contained in the student's guide: activities to be completed in preparation for the unit, unit objectives, student reading materials, individual and group learning activities, case study, discussion questions, assessment questions, and references. Among the topics discussed in the unit are the following: the importance of financing to a new business' success, reasons financing is needed, personal risks involved in financing businesses, sources of equity financing, sources for borrowing money, financial statements included in business plans, the importance of a good credit rating, and ways lenders evaluate loan applications. (MN)

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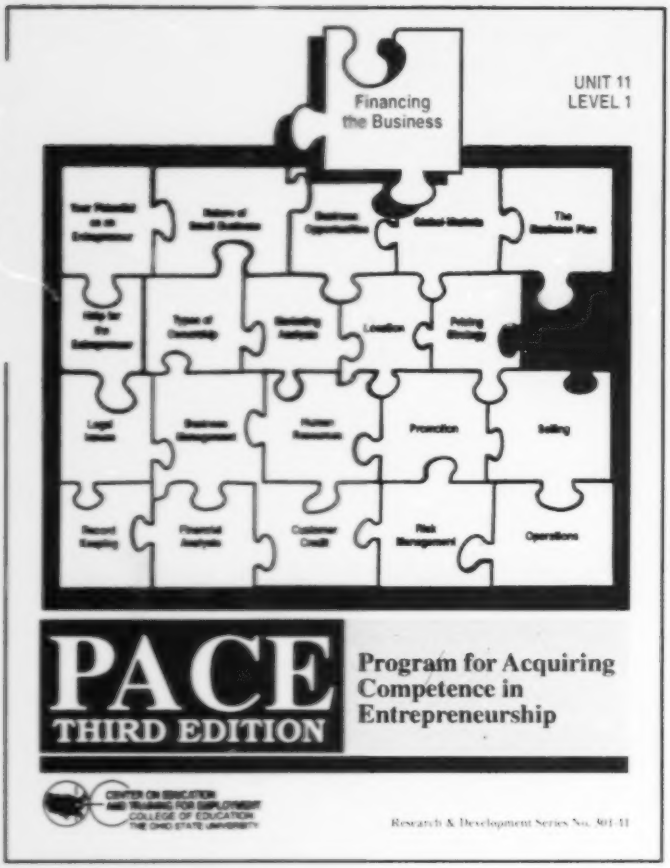

INSTRUCTOR GUIDE

Unit 11

Financing the Business

Level 1

HOW TO USE PACE

- Use the objectives as a pretest. If a student is able to meet the objectives, ask him or her to read and respond to the assessment questions in the back of the module.
- Duplicate the glossary from the *Resource Guide* to use as a handout.
- Use the teaching outlines provided in the *Instructor Guide* for assistance in focusing your teaching delivery. The left side of each outline page lists objectives with the corresponding headings (margin questions) from the unit. Space is provided for you to add your own suggestions. Try to increase student involvement in as many ways as possible to foster an interactive learning process.
- When your students are ready to do the *Activities*, assist them in selecting those that you feel would be the most beneficial to their growth in entrepreneurship.
- Assess your students on the unit content when they indicate they are ready. You may choose written or verbal assessments according to the situation. Model responses are provided for each module of each unit. While these are suggested responses, others may be equally valid.

Objectives:

- Discuss the personal risks involved in financing the business.
- Explain the difference between operating expenses and start-up costs.
- Describe methods of financing a new business.
- Discuss the importance of having a good credit rating.

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Objectives	Teaching Suggestions
1. DISCUSS THE PERSONAL RISKS INVOLVED IN FINANCING THE BUSINESS	
How important is financing to the success of a new business?	Introduce the concept of business financing. Emphasize the importance of planning for financing to ensure successful business operations.
What personal risks are involved in financing the business?	Invite a local entrepreneur to speak about personal risks involved in financing his/her business.
2. EXPLAIN THE DIFFERENCE BETWEEN OPERATING EXPENSES AND START-UP COSTS	
What do you need the money for?	Define start-up costs and operating expenses. Use a chalkboard or an overhead to show examples of each. Help students understand what personal expenses are and explain why entrepreneurs need to evaluate these expenses prior to starting a business.
3. DESCRIBE METHODS OF FINANCING A NEW BUSINESS	
Where do you get the money for financing a new business?	Define the concepts of equity financing and debt financing. Start the discussion by reminding students of the fundamental equality underlying the balance sheet (i.e., Assets = Liabilities + Owner's Equity). Use a simplified approach to explain debt financing and equity financing based on this equation (e.g., to purchase assets, the business "uses up" its debt or equity).
What are the sources of equity financing?	Review the new concepts introduced in this unit. Show a chart with methods of equity financing. Keep your explanations simple to help students understand the meaning of the terms. If students have difficulties in grasping the meanings of the concepts, reuse the fundamental equation mentioned above to simplify your explanations.
What are the sources for borrowing money?	Invite a local banker to speak about ways used by banks to approve loans. Encourage the banker to speak about other sources of financing banks compete with in the market. In addition, the banker should explain what loans banks offer to businesses compared to what other financing companies offer.

Objectives	Teaching Suggestions
Are there other sources of financing?	Use a chart to explain franchises, trade credit, and factors as additional sources of financing. Explain the differences among these sources by using simple examples. Use a chart to show what financial information should be included in the business plan (i.e., balance sheet, income statement, cashflow statement, start-up costs, etc.). Explain why lenders need to see this money before approving loans.
What is an income statement?	Define income statement in simple terms and review how it should be developed. Explain what kind of information the income statement provides lenders.
What is a cashflow statement?	Use the income statement developed previously to explain how cashflow statement is derived (i.e., cash disbursements are subtracted from sources of cash, etc.). Make sure students understand how the cumulative cashflow is computed (i.e., Pre-operating cashflow = Sources of cash + Cash on hand - Start-up costs; Monthly cumulative cashflow = Previous month cashflow + cashflow generated in that month).
What is the balance sheet?	Use the above approach. Explain the meaning of various accounting entries in the balance sheet (e.g., current and fixed assets, depreciation, etc.). Show how Equipment, Net of Depreciation is computed (i.e., as the difference between Equipment & Fixtures and Depreciation). Also, explain the equation Net Equity = Beginning Equity + Retained Earnings - Withdrawals).
4. DISCUSS THE IMPORTANCE OF HAVING A GOOD CREDIT RATING	
Why is it important to have a good credit rating?	Have the banker speak about the importance of having a good credit rating.
How do lenders evaluate loan applications?	Use the above suggestion. The banker should explain to students what criteria are used by banks to evaluate loan applications.
What are the six C's of credit evaluation?	Use a chart to explain the six C's of credit evaluation.

MODEL ASSESSMENT RESPONSES

1. Personal risks involved in financing a business are (1) the inability of earning adequate funds from operations to cover living expenses. (2) risks associated with pledging personal assets, such as savings, automobile, home, etc. to obtain a loan (3) significant amount of stress due to potential family misunderstanding, and (4) possible personal credit rating changes as a result of business failure.

2. *Operating expenses* are expenses associated with running a business. They include utilities, insurance, salaries, taxes, advertising, supplies, rent, and other expenses necessary to keep the business going. *Start-up costs* are costs associated with starting a business. They include equipment, fixtures, starting inventory, real estate, one-time advertising for grand opening, and other purchases entrepreneurs need to make to open the doors of their businesses.

3. There are two basic forms of financing a business: *equity* and *debt financing*. Equity financing includes the personal savings of the owner, investments in the business made by family and friends, or funds obtained from selling a part of the business to others. Debt financing refers to venture capital or loans obtained by entrepreneurs from private and public investors and lenders, including SBA. Examples of loans include commercial and consumer loans, home equity loans, direct loans offered by SBA, revolving loans (offered by communities), etc.

4. It is important to maintain a good credit rating to convince lending institutions to approve loans. Good credit ratings also help entrepreneurs who desire to invest in franchises. The franchisors accept only franchisees with excellent credit rating. Moreover, suppliers and potential customers consider the credit rating of the business before deciding to close deals.

PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

Incorporates the needed competencies for creating and operating a small business at three levels of learning, with experiences and outcomes becoming progressively more advanced.

Level 1 — Understanding the creation and operation of a business.
Level 2 — Planning for a business in your future.
Level 3 — Starting and managing your own business.

Self-contained **Student Modules** include: specific objectives, questions supporting the objectives, complete content in form of answers to the questions, case studies, individual activities, group activities, module assessment references. **Instructor Guides** include the full text of each student module and lesson plans, instructional suggestions, and other resources. **PACE, Third Edition, Resource Guide** includes teaching strategies, references, glossary of terms, and a directory of entrepreneurship assistance organizations.

For information on PACE or to order, contact the Publications Department, the Center on Education and Training for Employment, 1900 Kenny Road, Columbus, Ohio 43210-1090 (614) 292-4353, (800) 848-4815.

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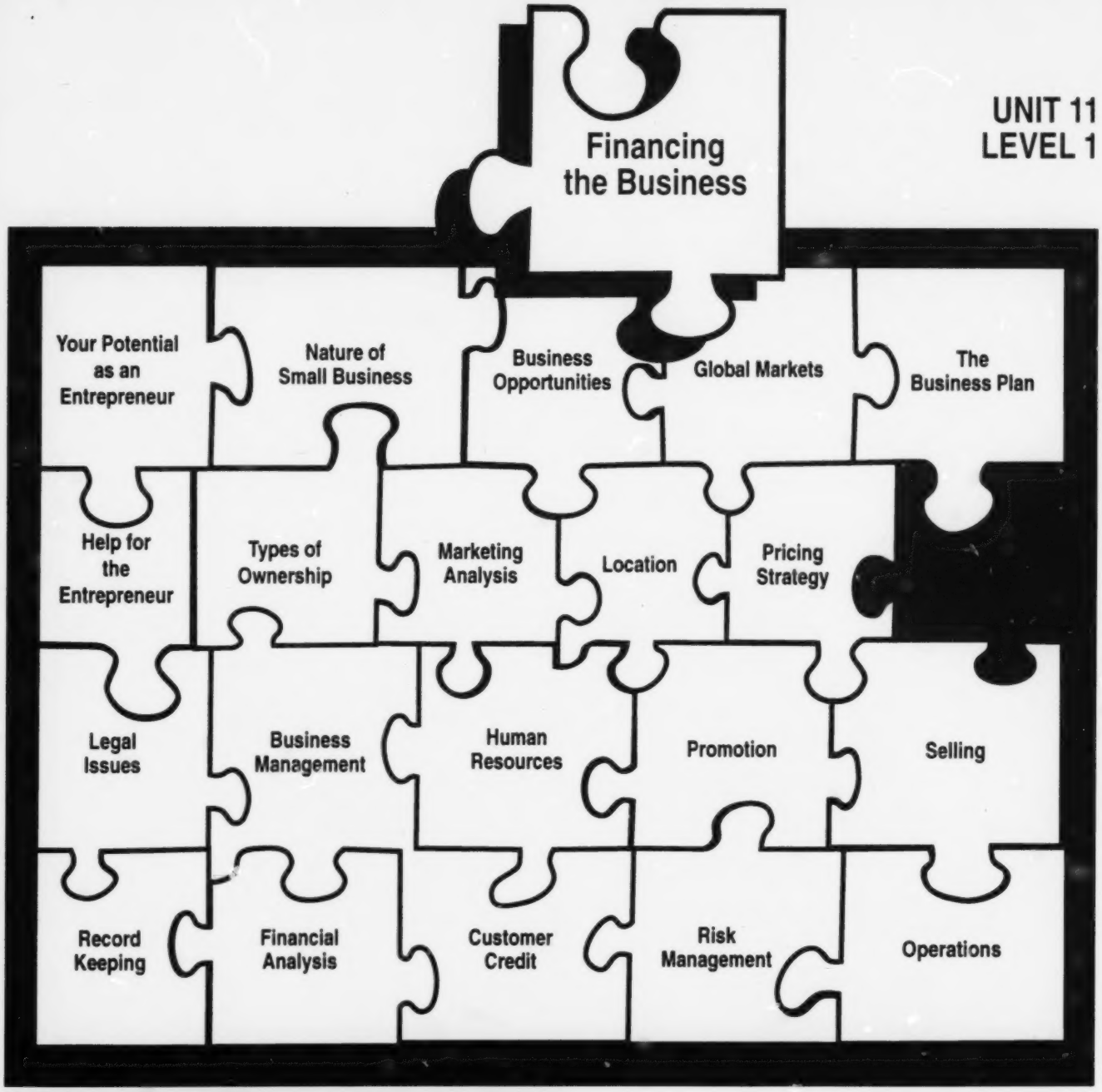
UNIT 11
LEVEL 1



PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

CENTER ON EDUCATION AND TRAINING FOR EMPLOYMENT
COLLEGE OF EDUCATION
THE OHIO STATE UNIVERSITY

Research & Development Series No. 301-11

FINANCING THE BUSINESS

BEFORE YOU BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read What are the Objectives for this Unit on the following page. If you think you can meet these objectives now, consult your instructor.

3. Look for these business terms as you read this unit. If you need help with the meanings, ask your instructor for a copy of the PACE Glossary contained in the *Resource Guide*.

Balance sheet
Bank guaranteed loan
Cashflow statement
Commercial finance company
Commercial/Personal loan
Consumer finance company
Credit union
Debt financing
Direct loan
Equity financing
Factor
Financing
Franchise
Home equity loan (Second mortgage)
Mortgage
Operating expenses
Profit and loss statement
Projected cashflow statement
Projected income statement
Revolving loan fund
Savings and loan institutions
Spreadsheet program
Start-up costs
Trade credit
Venture capital

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FINANCING THE BUSINESS

WHAT ARE THE OBJECTIVES FOR THIS UNIT?

Upon completion of this unit you will be able to—

- discuss the personal risks involved in financing a business,
- explain the difference between operating expenses and start-up costs,
- describe methods of financing a new business, and
- discuss the importance of having a good credit rating.

WHAT IS THIS UNIT ABOUT?

This unit examines the financing necessary to start a business. Money is needed for many different reasons. In this unit you will discover the various expenses involved in starting a business. Since many people don't have enough of their own money to get started, you will learn where you can go to borrow money and obtain other types of financing. People who lend or invest money will ask for a business plan, which helps them decide whether it is safe to lend the money for a new business. Included in the business plan is a projected profit-and-loss statement, cashflow statement, and balance sheet.

HOW IMPORTANT IS FINANCING TO THE SUCCESS OF A NEW BUSINESS?

Financing a new business means getting the money necessary to start it and to keep it going. Money is the fuel that powers the business. Just as a car won't run without gasoline, neither will a business run without money.

Besides the decision to start the business, the next important decision is how to finance the business. Too many businesses fail because of the lack of money to get them started and keep them going. If you were planning a 2,000-mile trip in your car, would you start out if you only had enough gas money for the first 500 miles? Probably not. Yet,

many people do this when they start a business, thus limiting their chances for success.

If you are going to start a business, it is important that you have enough money to complete the trip. Financing is one of the keys to a business's success. Without it, your chances of surviving and making a profit are poor.

WHAT DO YOU NEED THE MONEY FOR?

The first step in financing your business is to determine the need for money. There are many costs and expenses to consider. If you don't consider all your money needs, then you will start your business without enough money. Therefore, think very carefully about all of the things for which you will need money.

Three groups of costs and expenses are identified below to help you think about your money needs. The first group is called *start-up costs*. The next group consists of *operating expenses*. And the third group is called *personal expenses*.

Start-up Costs

Start-up costs are generally expenses that occur just once when getting the business off the ground. Once your business is started, you may not have these expenses again. Some examples of start-up costs are the following:

- Furniture, fixtures and equipment
- Starting inventory
- Deposits for rent, utilities and insurance coverages
- Business licenses and permits
- Certain legal and accounting fees
- Advertising for the grand opening

For example, if you were opening a restaurant, you would have many start-up costs. You would have to buy tables and chairs for your customers to sit on, ovens and fryers to cook your food, all the ingredients to make the items on the menu, and plates, knives, forks, and spoons. You would also have to buy or rent a building, pay for a business license and restaurant permit, and get your menu printed. And, these are just a few expenses. Think of all the other start-up costs you would have.

Operating Expenses

Operating expenses come after the business has been started. They are necessary to get the business on its feet and to keep the business operating on a daily, weekly, and monthly basis. Many businesses take a few months to a year or longer to begin to pay for operating expenses and to show a profit. Until there is enough income/revenue from sales to keep the business running, money will be needed for operating expenses. Some examples of operating expenses are these:

- Inventory

- Repairs to equipment
- Supplies
- Insurance
- Advertising
- Monthly rent
- Payroll
- Utilities
- Taxes

That is, once your restaurant is open, you will have regular operating expenses. You will have to buy food, pay the cooks and waitresses, pay sales tax, make monthly rent payments, and much more on a continual basis. It is important to determine how much money is needed each month to operate the business.

Personal Expenses

Personal expenses are those costs that are necessary for you to live. When you are employed, the wages you earn would be for your personal expenses. The money you need to start and operate the business is important. However, don't overlook the money you need for personal or living expenses. Here are some examples:

- Rent or mortgage payment
- Clothing
- Food
- Utilities
- Transportation
- Medical bills
- Insurance
- Entertainment

Many new businesses will not be profitable right away. Sometimes it takes one to three years for a business to become profitable.

The owner of a new business may not make enough from the business to cover personal living expenses. These expenses should be included among your money needs. Sometimes people start a new business while working another job, or their spouse earns money from an outside job. This helps to limit the money needed to cover personal expenses, thereby reducing the amount of money for financing the business.

WHAT PERSONAL RISKS ARE INVOLVED IN FINANCING THE BUSINESS?

If your business is not as successful as you expect, you may face the following risks.

- You may not earn adequate living expenses from business operations.

- You may risk personal assets such as savings, home, or automobile that are pledged as a personal guarantee for a business loan.

- You may undergo significant stress in your family life due to the financial uncertainty of running a business.

- You may damage your personal credit rating.

WHERE DO YOU GET THE MONEY FOR FINANCING THE BUSINESS?

After you determine what your money needs are and that you are willing to take the risks, you need to find out where you can get money to finance the business. There are two basic sources of money. First, most people who start businesses put in some of their own money as well as seek partners or investors. This is called *equity financing*. Second, the rest of the money that is needed is borrowed. This is called *debt financing*. Most businesses are started with both types of financing.

WHAT ARE THE SOURCES OF EQUITY FINANCING?

The main source of *equity financing* for most people is their savings. Some experts say that one-half of the money needed to start a small business should come from the owner. This may mean a future business owner must work and save for several years before having enough to start a business.

Another source of equity financing is money from family and friends. Family members such as mothers, fathers, brothers, sisters, aunts, and uncles frequently will provide money to help start a business. Friends, too, can be a good source. However, when using money from family and friends, there are a few points to consider. For example, will they want to get involved with operating the business? What happens if the business doesn't succeed? Will it ruin your relationship? Before using money from family and friends, it is important to consider the pros and cons carefully.

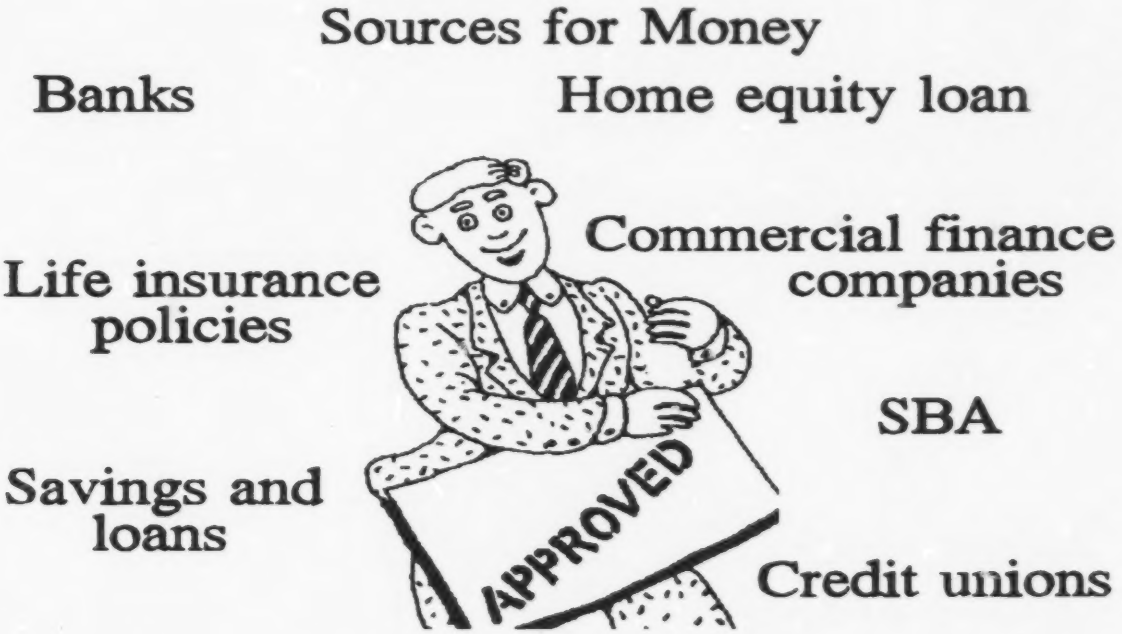
Equity financing can also be obtained by selling part of the business to others. This can be done several different ways. You could get one or more partners. With the partners putting in part of their own money, it is usually easier to raise the total amount needed. However, partners must be able to get along and make decisions that each accepts. Sometimes this is not easy. Since many people starting their own business want to make their own decisions, this alternative may not be realistic.

Incorporating the business and selling stock is also a way of raising equity capital. Again, this may not be acceptable to the owner, since it means giving up some control of the business. Legal and tax questions also must be considered.

Venture capital is sometimes available from companies and individuals. This money is usually not easy to locate and obtain. Many of the considerations concerning ownership also pertain to venture capital.

The most common arrangement is for the venture capital company to give money in exchange for a share(s) in the new company in the form of stock and for the venture capital company to have management participation. A form of venture capital is also available from Small Business Investment Companies. These companies are licensed and regulated by the federal government. They are eligible for federal loans that they may invest along with their own money.

lenders are careful not to lend money if the risks are great. Lenders want to be sure they will not lose their money on businesses that fail. Most lenders, therefore, will want to review the business plan carefully. This plan describes how the business will be operated, how much money will be needed and how it will be used, and when the business will be profitable.



WHAT ARE THE SOURCES FOR BORROWING MONEY?

The sources for borrowing money are limited only by the imagination of the owner. Whatever the source, lenders will usually lend money for starting businesses only to people they know and trust. Also,

Most people think of banks when borrowing money. Although it is true that banks lend money to help businesses get started, it is not always easy to borrow from them. Banks lend money only when the risk of losing it is very low. Most start-up business ventures do not fall into this low-risk category. Frequently, they will only lend to customers they have known for a long time.

If you are a member of a credit union, you may be able to borrow there. Many times, small loans are available for personal or business uses. Some loans can be obtained with just your signature. Also, credit union interest rates are frequently lower than bank rates.

Both *commercial* and *consumer finance companies* may lend you money to start your business. Commercial finance companies arrange *business loans*. On the other hand, *personal loans* are made by consumer finance companies. Both types of finance companies tend to lend money to people that banks may turn down. Because they take greater risks, finance companies usually charge high interest rates.

You may also want to consider a *home equity loan* (*second mortgage*) as a source of financing if you own your own home. Because these loans are personal in nature, the bank or savings institution will not assess the credit worthiness of your business proposal. It is especially important that you have your plan evaluated by objective, outside advisors before taking this step.

Some people borrow money against their life insurance policies. This is an easy way to obtain some of the money needed to start a business. Since life insurance policy loans are based on the cash already paid in, they are not risky and life insurance companies usually offer these loans at lower interest rates. However, it should be remembered that the amount borrowed is deducted from the coverage available to the beneficiaries until the loan is repaid.

If you need to buy land or a building for a new business, you may be able to borrow the money from a *savings and loan institution*. They specialize in real estate financing. The loans they make are called *mortgages*, and the savings and loan institution will hold the property as security for the mortgage loan. Their interest rates are similar to those of banks.

Another source of borrowing is the United States Small Business Administration (SBA). The SBA is a federal agency whose mission is to help small businesses get started and keep going. The SBA has two basic types of business loans. One type is called *bank guaranteed loans*. The money for these loans is actually provided by a bank that participates in the loan guarantee program. To convince the lender to make the loan, the SBA guarantees that it will be paid back. The SBA guarantees a percentage of the loan, not the total amount. The SBA may guarantee up to 90 percent of the loan. The bank assumes the risk for the other 10 percent. The other type of loan, made directly by the SBA, is called a *direct loan*.

SBA loans are available only if you are unable to borrow the money from a bank or other private lender. You have to try the other sources of borrowing previously mentioned before you are eligible for an SBA loan. The SBA has other programs that are designed to meet the special economic needs of particular industries, areas, and business people. Check with your nearest SBA office to evaluate your options.

Many communities have established *revolving loan funds*. These loan funds are comprised of various sources of public and private monies. This loan pool is specifically designed to assist businesses that are located within the community and that have potential for employing community residents. The loan application process will vary de-

pending on the regulations and laws governing the loan fund. Usually, there is a set amount of money within the fund, and limits on the amount of money one company can borrow from the fund.

Once all the money within the revolving loan fund is out on loans to various companies, no new applications for funds can be processed. At this point, there is no money to lend from the fund. When the companies with borrowed money from the loan fund begin to repay their loans to the fund, then new loans will be processed to new company borrowers.

ARE THERE OTHER SOURCES OF FINANCING?

Three additional financial sources commonly used are *franchises*, *trade credit*, and *factors*. Although franchises and trade credit can be used to get the business started, factors normally are not used until the business is actually in operation.

Starting a new business as a *franchise*, such as "Dunkin' Donuts" or "Kentucky Fried Chicken," has advantages. One advantage is help in financing the business. Buying a franchise may help you go into business for less money than if you started a similar business by yourself. Sometimes the franchiser will let you put a small cash payment down and then lend you the rest of the money needed to get the business started.

NOTE: Business techniques that reduce your start-up costs are actually less expensive sources of start-up financing than either borrowing or seeking investors.

Trade credit is another good source of financing. This is usually short-term credit that suppliers provide to their customers. In small businesses, trade credit is widely used. Many small businesses buy the products they sell or the equipment they use on trade credit. Trade credit for *buying your inventory* may be for 30, 60, or 90 days. Trade credit for *buying equipment* is frequently longer. Also, trade credit is often difficult to establish until you have been in business for a time.

Factors are businesses that buy another company's accounts receivable. Suppose you started a clothing store and provided your customers with charge accounts. Customers may buy clothes from you and then take several months to pay you back. Using a *factor* would help you get cash to pay your operating expenses. The factor would give you the cash and take over the credit charges or accounts receivable of your customers. The factor would charge you a fee for this service. However, it is a good way of getting cash when you need it without borrowing. Also, you need to consider the impact on your customers of having another firm handling their billing and collections.

WHAT ARE THE FINANCIAL STATEMENTS INCLUDED IN THE BUSINESS PLAN?

Because of the risk involved in lending money to start new businesses, lenders want to see a business plan. This plan describes in detail how the business will operate, and

through financial statements, projects how successful the business will be. Usually the business plan will include three interrelated financial statements: (1) a projected income statement, (2) a cashflow statement, and (3) balance sheet. All three are covered in more detail in PACE Unit 18, Financial Analysis.

WHAT IS AN INCOME STATEMENT?

The *income statement* is a financial tool that businesses use to compare expenses to profits. Its purpose is to show the results of the firm's operations on its profit or loss during a particular time period.

When you are planning a new business and looking for the money to get it started, you do not have a real income statement to show lenders or investors. You will have to estimate or project what will happen based upon your assumptions, industry-wide averages, and local conditions. Lenders and investors are interested in when you will make a profit and how large it will be. This information helps them decide the degree of risk and the terms of the agreement with you that they are willing to accept in order to finance your business venture.

The projected income statement presented in Figure 1 consists of five parts:

- Projected total sales
- Projected costs of goods sold/cost of sales
- Projected gross profit
- Projected operating expenses
- Projected net profit

As you can see the income is presented monthly for the first year of operation. Most small businesses do not make a profit right away. In this example, the business does not show profit until the fifth month.

WHAT IS THE CASHFLOW STATEMENT?

The cashflow statement estimates how much cash will come in and go out of the business each month. Its purpose is to help the business owner avoid or plan for cash shortages or surpluses. It tells you when you will need to find additional funds and when you will have cash left over. The sample cashflow statement presented in Figure 2 illustrates this.

The first part lists the sources for cash. The second part lists the disbursements, or where the cash will go. Subtracting the disbursement from the cash sources tells you the amount of cash left over or the additional amount of cash needed to cover the expenses for the month.

The projected cashflow of your business is important. Remember, cash is the fuel that makes your business function. You need to know the amount of cash available to buy new merchandise or whatever else you need to keep the business operating.

Alex's Hardware
Projected Income Statement for the Period January 1, 1996—December 31, 1996

	Jan	Feb	March	April	May	June	July	August	Sept	Oct	Nov	Dec
Gross Sales	$1,000	$1,500	$1750	$2,000	$3,000	$3,000	$3,500	$4,000	$4,500	$5,000	$6,000	$7,000
Less Cost of Sales	750	850	900	950	1,150	1,150	1,250	1,350	1,450	1,550	1,750	1,950
Gross Profit	250	650	850	1,050	1,850	1,850	2,250	2,650	3,050	3,450	4,250	5,050
Less Expenses												
Salaries	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Payroll Taxes	100	100	100	100	100	100	100	100	100	100	100	100
Advertising	50	50	50	50	50	50	50	50	50	50	50	50
Supplies	50	50	50	50	50	50	50	50	50	50	50	50
Utilities	100	100	100	100	100	100	100	100	100	100	100	100
And Other	200	250	300	300	350	300	350	400	400	450	450	500
Total Expenses	1,500	1,550	1,600	1,600	1,650	1,600	1,650	1,700	1,700	1,750	1,750	1,800
Net Income	(1,250)	(900)	(750)	(550)	200	250	600	950	1,350	1,700	2,500	3,250

Figure 1. Alex's Hardware projected income statement (January 1, 1996 - December 31, 1996)

Alex's Hardware
Projected Cashflow Statement for the Period January 1, 1996—December 31, 1996

	Pre-Operating	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
Sources of Cash	$20,000												
Cash on Hand	25,000												
*Net Profit		(1,250)	(900)	(750)	(550)	200	250	600	950	1,350	1,700	2,500	3,250
Total Cash Inflow	45,000	(1,250)	(900)	(750)	(550)	200	250	600	950	1,350	1,700	2,500	3,250
Disbursements													
Start-up Costs	25,000												
Owner's Draw		1,000	1,000	1,000	1,000	500	1,000	500	1,000	500	500	1,000	1,000
Loan Payments				500			500			500			500
Insurance						400					400		
Income Tax					1,000								
Other					300		600			200			700
Total Cash Outflow	25,000	1,000	1,000	1,500	2,300	900	2,100	500	1,000	1,200	900	1,000	2,200
Net Cashflow		(2,250)	(1,900)	(2,250)	(2,850)	(700)	(1,850)	100	(50)	150	800	1,500	1,050
Cumulative Cashflow	$20,000	17,750	15,850	13,600	10,850	10,050	8,200	8,300	8,250	8,400	9,200	10,700	11,750

Figure 2. Alex's Hardware projected cash flow statement (January 1, 1996 - December 31, 1996)

*NOTE: Net profit is carried over from the Projected Income Statement.

WHAT IS THE BALANCE SHEET?

The balance sheet shows how the business stands at the end of the year. The assets of the business are balanced against the liabilities and equity. Ideally, the assets of the business will be larger than the liabilities, therefore increasing equity or net worth. The equity or net worth determines the value of your company.

Figure 3 is an example of what a projected balance sheet looks like.

HOW ARE THESE FINANCIAL STATEMENTS RELATED?

It is important to begin to see the relationships among the three statements. The "snap-shot" of your business' financial position taken by the balance sheet is the result of the operations described by the income statement and the cashflow statement. For example the *cash on hand* item on the balance sheet is driven by the *cumulative cashflow* item for the last period. How many additional links can you discover among Figures 1, 2, and 3?

Because each of these projected financial statements are based on assumptions that may change as you develop your business plan, it is convenient to use a computer *spreadsheet program* to evaluate, and update the impact of a change in one item on the rest of the analysis. For example, a change in your assumed rate of monthly sales growth will have a significant impact on the cashflow and balance sheet results. These programs are available in the form of "templates" that handle the necessary mathematical relationships and allow you to specify the starting positions and assumptions.

To get your new business off to a good start, you must have adequate financial backing. You will need to identify start-up costs, operating expenses, and personal expenses. Next, you must decide how to finance your business. You will probably need to use some combination of equity and debt financing. Lenders will want to review your business plan. They will be particularly interested in your Projected Income Statement, Cashflow Statement and Balance Sheet. Gaining a thorough understanding of these business financial needs will greatly increase your chances of running a successful business.

WHY IS IT IMPORTANT TO HAVE A GOOD CREDIT RATING?

Your personal and business credit is evaluated constantly by all your current and potential business associates. Specific groups that have a direct interest in your history of meeting financial obligations include the following:

- Potential lenders evaluating your ability and willingness to repay their loan
- Potential equity investors judging the riskiness of their investment

Alex's Hardware
Projected Balance Sheet as of December 31, 1996

ASSETS		LIABILITIES	
Current Assets		Loan (Current Balance)	$23,000
Cash on Hand	$11,750	TOTAL	$23,000
Accounts Receivable	3,900		
Inventory	15,000		
TOTAL CURRENT ASSETS	$30,650	Beginning Equity	$20,000
		Retained Earnings	7,350
Fixed Assets		Less Withdrawals	(10,000)
Fixtures and Equipment	$9,950	Net Equity	17,350
Less Depreciation	750	TOTAL LIABILITIES AND EQUITY	$40,350
Equipment, Net of Depreciation	$9,200		
Other Assets			
Deposits for Utilities	500		
TOTAL FIXED ASSETS	$9,700		
TOTAL ASSETS	$40,350		

Figure 3. Alex's Hardware projected balance sheet as of December 31, 1996

- Franchise companies in which you have a potential interest are also interested in your personal credit record

- Suppliers from which you may seek to obtain trade credit

- Potential customers who may wish to place a long-term order that is crucial to their own businesses

A number of credit reporting services maintain comprehensive and extensive files on the credit history of businesses and individuals within the United States and other countries. You may wish to obtain a copy of your credit rating to check for errors or other problems that should be disclosed to your lender before they obtain it for themselves. You also need to consider these services when evaluating your suppliers, customers, and so forth, for credit extension purposes.

HOW DO LENDERS EVALUATE LOAN APPLICATIONS?

Now that you have completed the loan application package, the prospective lender must evaluate it to determine whether the loan should be made. The lender's main concern is with getting the loan repaid. Therefore, the lender is interested in the future of your business. Will you be able to survive, grow, and become profitable? Will you be able to repay the loan? This is what the lender must decide.

As the lender considers your loan application, there are usually four areas to review. Net earnings is one of these areas. Will your company generate enough income to sustain the business with enough left over to repay the loan? The immediate and long-range company outlook is another. Will there continue to be demands for your type of business in both prosperous and depressed times? Looking more broadly, industry outlook is another area to consider. Is your business part of a growing or dying industry? Will your industry still exist in a few years? The capability of your management is the fourth area. Do you have the managerial skills and motivation to make a success of your business?

Besides reviewing these areas, the lender will evaluate the worthiness of an applicant with more specific criteria. In financial circles, these specific criteria are known as "the six Cs."

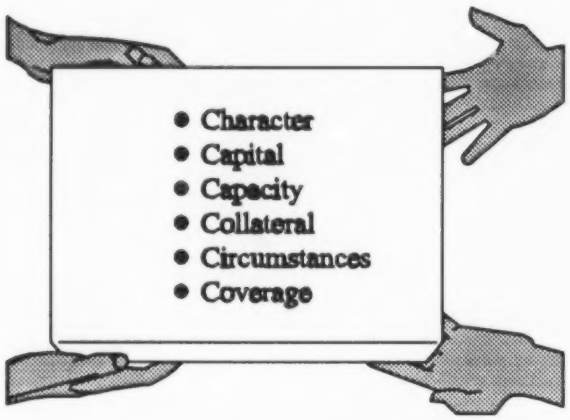
WHAT ARE THE SIX C'S OF CREDIT EVALUATION?

The six Cs used for evaluating credit applicants are as follows:

Character refers to the type of person you are. Some say it is the most important asset of an entrepreneur. Lenders evaluate a person's character according to such traits as honesty, reliability, and trustworthiness. To the lender, a person with strong character will do everything possible to protect the assets and the business and to ensure that the loan will be repaid.

Capital is the amount of money that the entrepreneur has personally put into the business. Your personal investment shows the

Six C's of Credit Evaluation



lender your faith and commitment in the growth and eventual success of the company. Expect to put in 30 percent or more of your own funds to illustrate this level of faith and commitment.

Capacity relates to the skill and drive of management. A lender is interested in leadership that has clear goals and a detailed plan for seeing the business prosper. An effective management will utilize the loan to assist the business to grow and succeed. These first three criteria represent the original *three C's of consumer credit.*

Collateral is the security the borrower puts up to ensure that the loan will be repaid. Normally, tangible-assets collateral are forfeited to the lender if the loan is not paid. The better the collateral, the more assured the lender is that the loan will be covered.

Circumstances are other factors that lenders consider that may be beyond the control of the borrower. They must be considered because they may have an effect of the repayment of the loan. The state of the economy, the nature of the borrower's competition, and the nature of the product or service being sold are examples of circumstances reviewed by lenders.

Coverage deals with insurance protection. The lender is interested in the loan being repaid if something unforeseen happens to the owner of the business. Insurance that covers the death of the borrower or losses due to physical damage, liability, or theft help guarantee that the loan will be repaid.

The thorough lender will weigh the applicant's character, capital, capacity, collateral, circumstances, and coverage very carefully before making a loan to any entrepreneur. Knowing this should help you plan your loan application package and interview with the lender.

ACTIVITIES

The following activities are designed to help you apply what you have learned in this unit.

INDIVIDUAL ACTIVITIES

A.

Identify each of the costs and expenses listed below as either—

- start-up,
- first-year operating, or
- personal living

On a separate sheet of paper, number from 1 to 10. Beside each number, write the first letter of the appropriate type of cost for each of the 10 items below. Use S for start-up, F for first-year operating, and P for personal living.

1. Payroll
2. Business license
3. Monthly rent
4. House payment
5. Beginning inventory
6. Medical bills
7. Advertising for grand opening
8. Equipment repairs
9. Deposits for utilities
10. Clothing

B.

Identify each of the sources of financing listed below as either equity financing or debt financing. On a separate piece of paper, number from 1 to 10, and beside each number, write the first letter of the appropriate answer to the 10 items below. Use E for equity financing and D for debt financing an O for other.

1. Commercial bank
2. Personal savings
3. Forming a partnership
4. Life insurance company
5. Small Business Administration
6. Venture capital
7. Consumer finance company
8. Incorporating the business
9. Credit union
10. Family and friends
11. Suppliers
12. Factors

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GROUP ACTIVITIES

A.

Work in teams of four to six. Ask each group member to list as many different start-up costs for opening a small pizza takeout restaurant as possible. Take five minutes to do this.

Next, compare team members' lists by making a comprehensive list that includes every different start-up cost mentioned. Discuss the start-up costs listed and determine whether there are others that no one thought of. If the group thinks of any more, add them to the list. An optional step to this activity is to share team lists. Check to see if your team left out any start-up costs that others included.

As an option, discuss start-up costs with an owner of a pizza takeout restaurant or have the owner talk to the entire group.

B.

Continue working in teams. The team members convene to discuss the computations used to develop the balance sheet, income statement and cashflow statement presented in this unit. Each group member is supposed to work out a computation for the various entries in these statement using different dollar amounts. Then, the team will discuss what kind of information bankers can derive from the financial statements.

CASE STUDY

Juanita Owens has worked the past five years as the crew chief for the morning shift at a large bakery shop. She has had responsibility for overseeing the total operation from 4 a.m. until noon.

During this time, she has learned much about the bakery business. She knows both the backroom and front-end of the operation. In addition, Juanita has observed the customers carefully. She has learned the importance of satisfying the needs and wants of consumers.

Juanita has always wanted to start her own bakery. Within the last few months she has concluded that there is a need in her community for a bakery that also provides an in-store eating area with coffee, milk, and other beverages.

Because of her experience working in the bakery business, Juanita feels that she is now ready to open such a business. Of course, the first thing Juanita thinks of is money. She is not a wealthy person. She wonders where she could get the money to open her dream bakery.

DISCUSSION QUESTIONS

1. Explain to Juanita the importance of financing to the success of her business.

2. Describe to her the two main methods of financing a new business.

3. Tell Juanita about the various sources for getting the money to start a new business.

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ASSESSMENT

Read the following questions to check your knowledge of the topics presented in this unit. When you feel prepared, ask your instructor to assess your competency on them.

1. Discuss three personal risks involved in financing a business.

2. Explain the difference between operating expenses and start-up costs, and provide several illustrations of each type.

3. Describe methods of financing a new business.

4. Discuss the importance of having a good credit rating.

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PACE

Unit 1. Your Potential as An Entrepreneur
Unit 2. The Nature of the Small Business
Unit 3. Business Opportunities
Unit 4. Global Markets
Unit 5. The Business Plan
Unit 6. Help for the Entrepreneur
Unit 7. Types of Ownership
Unit 8. Marketing Analysis
Unit 9. Location
Unit 10. Pricing Strategy
⇨ Unit 11. Financing the Business
Unit 12. Legal Issues
Unit 13. Business Management
Unit 14. Human Resources
Unit 15. Promotion
Unit 16. Selling
Unit 17. Record Keeping
Unit 18. Financial Analysis
Unit 19. Customer Credit
Unit 20. Risk Management
Unit 21. Operations
Resource Guide
Instructor's Guide

Units on the above entrepreneurship topics are available at the following levels:

* Level 1 helps you understand the creation and operation of a business
* Level 2 prepares you to plan for a business in your future
* Level 3 guides you in starting and managing your own business